

FSC Newsletter

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**Financial Services
Commission**

Introduction

This newsletter is directed at Experienced Investor Funds (EIFs), EIF directors and EIF service providers.

The purpose of this newsletter is to improve the registration process and subsequent interfacing between the Commission and the EIF (and/or relevant service providers) by setting out the Commission's expectations on a number of areas where generic issues have emerged.

This Newsletter does not purport to give guidance but aims to set out the FSC's expectations in relation to a number of common themes identified since the inception of the EIF regime which, the FSC feels, will assist the registration process and interfacing with the FSC.

This newsletter will be particularly useful for new EIFs or people new to the industry. However, it may also assist existing EIFs who should consider these points in future amendments to its documentation.

Name of the fund

The FSC expects the name of a fund to reflect the actual investment strategy of the fund and under no circumstances should the name be misleading. When dealing with name approvals for EIFs, the Commission is requesting brief details of the fund's investment strategy/objective; details of the fund's proposed service providers (including the directors and EIF authorised directors); the names of the promoters/principals; proposed launch date and whether the fund is to be an open-ended or closed-ended structure.

Fund service providers

The Commission would expect offering documents to contain sufficient information on all of the fund's service providers. This is particularly important in the case of investment advisors/managers.

The FSC considers it good practice to provide details of the duties that specific service providers will be undertaking. This could, for example, take the form of a summary of the duties from the service agreement between the two parties.

The regulatory status of all of the fund's service providers should also be specified i.e. is the entity regulated and if so by whom or, if the entity is not regulated, the reason/exemption for this.

Additionally, the Commission would expect offering documents to include the manner in which service providers may be removed, such as through giving notice of a certain period. This stems from Regulation 14(2)(d) of the Financial Services (Experienced Investor Funds) Regulations.

Corporate Directors

Where the corporate director is to be appointed as an investment director this should be clearly set out in the offering document.

The Commission would expect sufficient information to be included in the offering document in respect of corporate directors. This should include the identity of the



directors behind the corporate director and any pertinent background on these individuals. The regulatory status of the corporate director should also be included i.e. is the entity regulated and if so by whom or, if the entity is not regulated, the reason/exemption for this.

Corporate Directors should not be used as a way of avoiding regulation as an investment firm under the Financial Services (Markets in Financial Instruments) Act.

Conflicts of Interest

It is inevitable that some conflicts of interest may arise, especially given the size of the jurisdiction. However, conflicts should be documented and managed by the EIF board. The offering document should also identify the potential conflicts and any mitigation in place. For example, as seen on various instances by the Commission, if an EIF director is also the director of the fund administrator, this information should be specified in the offering document. Likewise any other instances of common directorships between the different service providers should also be specified in the offering document.

Where a lawyer is an authorised director to the fund he/she should not be the person to have provided the legal opinion required by the Regulations. The FSC considers the signing-off of a fund's compliance with the EIF Regulations by a legal adviser, who is also appointed to the Board of the EIF, a conflict of interest which should be mitigated accordingly. This is not to say that the Board member and legal opinion cannot be provided by different individuals working within the same law firm.

Notification of material changes to subscribers

The EIF's offering documentation should set out how changes to the fund will be notified to subscribers. The Commission would expect the offering document of EIFs to establish and set out clearly the types of changes which would necessitate prior approval from the subscribers of the fund. The offering document should also include instances where subscribers would only require notification of the change after the change has been effected.

Investment Strategy

EIFs should ensure that their investment strategies are clearly set out in the offering documents. The investment strategy should provide sufficient detail to allow the investor to determine what the fund will be investing in as well as the underlying assets of the fund. Where possible this should also include time horizons and the manner in which the fund will ensure that its investment goals are achieved. If a fund will be availing itself of the services of an investment manager or an investment director, the investment strategy should also include details of their expertise.

Changes to the investment objectives of a fund would require pre-notification to existing investors (please see the Material Change section).

Investment decisions/oversight

Where the fund makes its own investment decisions, it is important that these decisions and how these are reached are satisfactorily documented. When investment decisions are made by one board member or an investment manager (corporate or individual), the authorised directors must ensure there is adequate oversight of that director and that the fund's investment objectives are adhered to.



Additionally, where appropriate, there should be sufficient evidence of adequate discussion/challenge of the the investment director/manager's proposals.

Directors' understanding of underlying investments of a fund

The Commission expects all directors of an EIF to understand the nature and the perceived risks of an EIF's underlying investments and how the board ensures compliance with the objectives of the fund. Where the EIF directors do not have expertise in the particular underlying investments they should ensure that there are other directors, members of an advisory board or similar who will be providing recommendations to the board.

Liquidity

EIF directors should ensure that they have a process in place to monitor the liquidity of a fund; this should include oversight of subscriptions and redemptions as well as changes in the underlying assets. This is of particular importance for open ended funds.

Risks

The Commission would expect that sufficient details on the potential risks perceived be included in all EIF offering documents. Risks should be specific to the investments that the fund will be undertaking.

Sub-funds and PCCs

The Commission discourages the use of PCCs and sub-funds to, for example, cut costs. We would expect each fund and sub-funds to be similar and where there is disparity between the asset class and investment strategy of different cells within the same fund, the FSC is of the opinion that the sub-fund or cell in question should be established as a separate EIF.

The Commission considers PCCs to be an appropriate vehicle in the following types of circumstances:

Where the cells hold similar assets but for different clients or with different strategies (i.e. one for capital growth, one for income etc).

Where similar types of assets are held but the cells are denominated in different currencies.

Where different types of assets are held but for the same customer (in limited circumstances).

The FSC does not consider it appropriate for different types of assets e.g. sports betting and equities, to be held in the same PCC. In our view, this dilutes the corporate governance and weakens the essential role of the approved director, as they may have little or no experience in the types of assets held in one of the cells. The Commission would also consider it irregular for different cells to be audited by different auditors.

Fund Assets

The FSC expects that the necessary care and diligence is applied when operating client accounts and that dual signatories are required. Permissions on bank accounts should be considered by the fund's Board and for example the principal should not be permitted to sign solely.



Pricing of assets and valuations

In calculating net asset valuations, the Commission is of the view that, the value of the underlying assets of a fund should be independently verified through, for example, the use of Bloomberg, or independent valuers. Although, with hard to value assets, this may be more of a challenge, funds should aim for there to be an independent valuation when ascertaining the initial value of the fund's assets and at regular intervals thereafter. Details of the pricing process should also be provided in the offer document.

The EIF's board should exercise due diligence over pricing at all times.

The Commission also expects that funds ensure compliance with the IOSCO principles of valuation as follows:

1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.
2. The policies should identify the methodologies that will be used for valuing each type of financial instrument held or employed by the hedge fund.
3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.
4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.
5. The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.
6. The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the Manager.
7. The policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an Independent Party.
8. The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.
9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

Errors

Firms should consider a process for any errors made during the valuation process and whether details of this, particularly actions to be taken in the case of major errors, should be stated in the offer document. This should also be stated in agreements with fund administrators. The possibility of compensation to the investor and how this would be calculated should also be considered.

EIF Directors

If upon application for an EIF directorship licence, it appears that the applicant does not hold sufficient experience and expertise, the FSC may be in a position to grant the applicant a restricted licence limited to the provision of a directorship to one or more specific funds. This will, however, only be permitted where the board of said fund(s) collectively has sufficient fund related knowledge and experience. The onus here, therefore, is placed on the fund's second authorised director, and the fund's board more generally, to provide leadership and guidance. In such cases, applicants will be required to submit to the FSC evidence relating to the fund knowledge and experience of all of the individuals on the board in advance of receiving a notification for a new EIF.



A restricted licence may be expanded to a full licence to provide EIF directorships once the individual has been able to provide evidence that sufficient general knowledge, expertise and experience has been obtained.

Alternatively, an applicant may consider serving as a director, in addition to the two authorised EIF directors, in order to glean relevant knowledge in an effort to eventually be able to demonstrate that he has achieved the necessary levels of expertise and experience to allow an application for authorisation as an EIF director to be granted.

For the avoidance of doubt, the Commission does not encourage the use of corporate directors as approved directors of EIFs.

It is beneficial to include the fund's promoters within the Board. However, it is the Board as a whole who exercises governance of the EIF and it is not expected that one particular member exercise significant influence over the remaining Board members as this would put into question the governance that is exercised over the EIF.

The FSC encourages the appointment of professionals to EIFs Boards e.g. accountants, investment advisors and lawyers. The FSC takes the view that appropriate governance should be maintained at all times and individuals who are appropriately qualified to exercise such function should be appointed at all times.

Residence

Regulation 7(1) specifies that an EIF must have "at least two Gibraltar resident directors authorised by the Authority to act as the director of an experienced investor fund" (underlining included for illustration purposes only). In determining whether to authorise an individual as an EIF director, the FSC will therefore consider how said individual meets this particular requirement. An individual must either be physically resident in Gibraltar, or, if resident across the border, must have a tenable link with a Gibraltar firm either as an employee, director or similar. In either case, the individual must provide a notice address in Gibraltar for delivery of any formal correspondence and notifications. Said notice address will be reflected on the face of the licence issued and it is expected that this will correspond with the place of work of the applicant or residential address of the applicant in Gibraltar.

Marketing of EIFs

An EIF is not passportable and therefore those marketing the fund should ensure that they comply with the relevant regulations in the jurisdiction in which the fund is being marketed.

Notifications to the FSC

The FSC expects EIF service providers, including authorised EIF directors, to report promptly to the FSC any potential or material function failure which could have a significant impact upon the fund, such as investors suffering significant financial loss as a result of for example an unprecedented event, negligence, an error etc.

Deregistration of EIFs

When a fund is in the process of deregistering, it is essential that subscribers' interests are considered in decisions made by the board. The FSC would also expect that subscribers be kept informed.



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Any advice or interpretation covered in this Newsletter represents the views of the FSC as to its expectations of how the requirements of the relevant legislation in question is to be complied with and/or how it fails to be applied. This, however, is not intended as a definitive interpretation of the applicable legislation which is ultimately a matter for the courts to determine. The FSC does not provide, or purport to offer, legal advice.